

**Trust planning**

Why you and your family might need a living trust

Who should be your trustee?

**Tax planning**

Don't rush that rollover

**Estate planning**

When is an executor personally liable for estate taxes?

# Trust UPDATE



## Why you and your family might need a living trust

*New perspectives on revocable living trusts*



One of the most useful and flexible wealth management tools is the revocable living trust. Traditionally, we like to point to three basic benefits that these trusts offer.

**Professional asset management.** After studying your goals and circumstances, our asset-management specialists will map out a diversified investment program appropriate to your requirements. Like many of our customers, you may authorize us to select specific investments on your behalf, confident that we will carry out this responsibility faithfully. (We have no securities to sell, nor do we receive commissions on purchases and sales. Our annual compensation is limited to the moderate fees that we charge as trustee.) Or, if you prefer, you may have each proposed investment change submitted for your approval. Our objective is not only to add to your financial security, but also to give you more opportunity to enjoy it.

**Uninterrupted family financial protection.** A living trust agreement can instruct us to perform a wide variety of special tasks when the need arises. These tasks might be as simple as paying a world traveler's quarterly estimated taxes while he or she is out of the country . . . or as complex as handling all household financial matters for a customer who has suffered a stroke and needs a housekeeper and nursing home care.

Older men and women often find this "future protection" aspect of our services especially attractive. With proper planning, living trusts can do much to avoid the financial management problems that arise during a prolonged period of incapacity—problems that might otherwise have to be dealt with by a court-appointed conservator.

**Probate avoidance.** Assets placed in a living trust are said to avoid probate because these assets are removed from your "probate estate"—the estate controlled by your will. Trust assets are distributed to beneficiaries, or held in continuing trust, as you direct in the trust agreement. Thus, using a living trust as the core of an estate plan usually leads to reduced settlement costs.

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More importantly, delays are avoided. For example, a married person's living trust can simply keep operating, uninterrupted by estate-settlement procedures, for the benefit of the surviving wife or husband. Living trusts also help to keep estate plans private. Unlike probated wills, provisions for the distribution of assets contained in living trust agreements do not normally go on public record.

### New perspectives

But living trusts can do more. Noted estate planner Martin Shenkman explored new perspectives on trust benefits in an article in a professional journal last February ["How to Avoid Complicated Trust Issues," *Bank Investment Consultant*]. Among the emerging benefits he identified:

**Minimizing identity theft.** The problem of identity theft has exploded in recent years. A funded revocable trust may have its own tax ID number, rather than using the settlor's own Social Security Number. In the event that the settlor's Social Security Number is compromised, the trust assets still will be protected.

**Protecting aging retirees.** More and more retirees are lasting longer than 20 years, and more and more elderly are developing some level of cognitive impairment. A living trust can provide for successor trustees as the beneficiary's abilities decline. Checks and balances can include co-trustees or trust protectors. A care manager plan also might be included, to provide annual or quarterly assessments of how the beneficiary is doing.

**Serving disabled loved ones.** A revocable trust may contain special-needs language to provide for an ill relative or incapacitated adult child. The trust also may provide for successor trustees should the caregiver become incapacitated.

**Asset protection in divorce.** If gifted or inherited assets are segregated into a trust, they won't be commingled with other marital assets. As such, those assets won't be vulnerable in a subsequent divorce proceeding.

Notwithstanding the decline in estate planning attributable to the increase in the federal exemption from estate taxes, attorney Shenkman predicted that the traditional and emerging benefits associated with revocable living trusts will make them an essential part of late-stage life planning for years to come.

### To get started

To set up a living trust with us, you give us your instructions in a

## Checklist of living trust benefits

- Professional asset management
- Uninterrupted family financial protection
- Probate avoidance
- Family financial privacy
- Minimizing identity theft
- Protecting aging retirees
- Serving disabled loved ones
- Asset protection in divorce

trust agreement, prepared by your attorney, and transfer the stocks, bonds, investable cash or other assets that you wish to place in your trust. Because the trust agreement is revocable, you can cancel the arrangement if ever you find it unsatisfactory. You also remain free to add assets, withdraw assets, or modify the terms of the trust.

Can resourceful management and responsive financial services eliminate all threats to financial security? Not quite. Always there remains an element of luck. But as a wise person has said, you can't hope to be lucky. You have to prepare to be lucky.

We look forward to assisting you in your preparations. □



## Who should be your trustee?

*To unleash the power of a living trust as a wealth management tool, you need to select the best trustee for your family. Here are seven good reasons to place your trust in our care.*

**1. Group judgment.** Our trust investment committee monitors the investments in the trusts in our care.

**2. Reliability.** We understand the special responsibilities of a trustee. All trust funds in our care are safeguarded by both internal and external audits.

**3. Experience.** Trusteeship is our business.

**4. Responsiveness.** Financially successful individuals and their families expect personal attention and responsive service. We deliver.

**5. Objective investment guidance.** Unlike investment advisors who are compensated mainly by sales commissions, we earn our trustee's fee by providing our trust clients with unbiased, personalized guidance.

**6. Convenience.** From bill paying to retirement planning, we can provide or obtain just about any convenience or special service that our trust clients desire.

**7. Neutral arbiter.** When trust provisions permit discretionary invasions of principal in specified circumstances, our neutral judgment in exercising fiduciary powers may help smooth disagreements among beneficiaries.

# Don't rush that rollover

In most cases when one receives a lump sum distribution from an employer's retirement plan, the best tax option is to roll the entire amount over into an IRA. That preserves the tax deferral for the retirement money for years, potentially for decades.

However, there is an important exception to this conventional wisdom. If the lump sum includes employer securities, there is an alternative tax strategy to look at. The distribution of employer securities from an employee stock ownership plan or a 401(k) plan will have two components for tax purposes. First, there is the value of the shares when they were acquired by the retirement plan. Then there's the growth in the value of the stock while it was held by the qualified plan, which is called *net unrealized appreciation* (NUA).

## Choices

In the year that the lump sum is received, the cost of the employer securities will be taxable at ordinary income rates. The NUA will not be taxed until the shares are sold, and then it will be taxed at long-term capital gain rates. This is true even if the shares are sold in the same year as they are received.

**Example 1.** At retirement Oscar received 2,000 shares of Old Employer stock, valued at \$100 per share. The average cost basis of the shares was \$25. Accordingly, Oscar will have \$50,000 of ordinary income, and \$150,000 of NUA. If he's in the top tax bracket of 39.6%, that comes to a \$19,800 income tax.

Alternatively, Oscar could arrange to roll the employer securities into an IRA. Then he would pay no tax in the year of the distribution, and all his money would be growing to build a larger capital base for retirement. The trouble with that approach is that the NUA advantage is lost, as all the distributions from the IRA will be taxed as ordinary income.

If Oscar were to sell all the shares and realize the \$150,000 gain, he would owe \$30,000 in long-term capital gain taxes if he is in the top bracket of 20%. (Note that the 3.8% surtax that applies to investment income of top taxpayers does *not* apply to distributions, such as Oscar's, from qualified plans.) That's roughly half of the tax he would pay when his IRA sold the shares and distributed the proceeds to him, assuming he's still in the top tax bracket during retirement.

## Having your cake and eating it, too

There is a middle ground to consider. In Private Letter Ruling 8538062, the IRS held that a partial rollover of employer shares to an IRA could eliminate income taxation in the year of the lump sum, and the remaining shares still could enjoy NUA treatment.

**Example 2.** Oscar rolls 500 shares of Old Employer stock into an IRA, with a value of \$50,000. According to the ruling, the rollover eliminates the \$50,000 ordinary income



that otherwise would be taxed. The remaining shares may be held in a taxable portfolio, and all of the NUA is attributable to them, so they have a cost basis of zero.

What happens when Oscar sells those shares in five years? Let's assume that they have grown in value to \$175,000. If Oscar is in the top tax bracket, and if capital gains tax rates have not been changed again by Congress, \$150,000 of the gain will be taxed at 20%, and the remaining \$25,000 will be taxed at 23.8%. Any growth in value after the distribution of the shares is not considered to be received from a qualified plan, and so it is subject to the surtax.

## One more twist

If Oscar has philanthropy as one of his estate planning goals, he might consider funding a charitable remainder trust with the employer securities received in the lump sum distribution. A charitable income tax deduction will be computed on the full fair market value of the shares. The charitable trust can sell the shares with no tax consequences. This can provide valuable portfolio diversification at no tax cost. Oscar may reserve a lifetime income for himself from the trust, and a portion of it may be taxed at long-term capital gain rates.

## See your tax advisors

If your retirement nest egg will include employer securities from a qualified retirement plan, you will have a number of important decisions to make, decisions that will affect your retirement security for the rest of your life. See your tax advisors to learn more about your choices and work through the numbers. □

## When is an executor personally liable for estate taxes?

At the time of his death, Melvin Sacks was legally married to Alvia Sacks but had been estranged from her for 25 years. His “longtime companion” was Lucille Atwell, with whom he jointly owned a brokerage account worth some \$2 million. Atwell was the beneficiary of Sacks’ life insurance policies. Sacks also had a relationship with Joan Parker, with whom he jointly owned a residence in Bayside, New York. The property was purchased in July 1990, for \$500,000, and Sacks provided the entire purchase price. He died the next month.

Sacks died with a substantial unpaid income tax from various years in the 1980s and 1990, well over \$1 million. As there were limited assets in the probate estate, the executor obtained a restraining order over the brokerage account. In March 1991 he also disaffirmed transfer of the residence to Parker. In November 1991 an estate tax return was filed reporting a taxable estate of \$3,208,103 and an estate tax liability of \$1,011,279. No taxes were paid at that time. In 1994 the IRS assessed an estate tax deficiency of \$831,313.

The income tax problem was resolved in December 1994, when the IRS accepted the executor’s offer in compromise to pay \$1 million to cover tax years from 1978 through 1990. The Surrogate’s Court authorized a release from the brokerage account, \$1 million for the IRS and \$28,000 to pay executor’s fees.

In 1997 Parker contributed \$87,500 to the estate to pay her share of the estate taxes, and two grandchildren contributed \$25,000 each. These amounts were forwarded to the IRS, but even so in February 1999 the outstanding amount due was more than \$3 million, including interest and penalties.

The executor asked the Surrogate’s Court in April 1999 to release additional funds from the brokerage account: (1) \$251,107 to the Estate of Alvia Sacks; (2) \$446,772 to the IRS; and (3) \$171,587 to the New York Department of Taxation. These amounts were paid. The IRS believed that payment to anyone other than itself, even a state taxing agency, was improper. It issued a notice of fiduciary liability for \$422,694 to the executor for the unpaid estate taxes.

The Tax Court in this case held that the Sacks estate was not insolvent at the time of the distribution, because it continued to have claims against those who received nonprobate property for contributions to pay the estate tax. Because the estate wasn’t yet insolvent, the executor was not personally liable for the tax.

This executor was fortunate. Most amateur executors do not fully understand the risks that they are taking. □



### Why are they so relaxed?

**They’ve funded their living trust, and so have handed off investment responsibilities to their trust officer.**

**Call us today to learn if a trust might be right for you.**



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